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The Reparation Problem

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I

THE way in which the reparation question was settled in the Peace of Versailles is probably unique in the history of international finance. Germany had to bind herself to make good the havoc she had wrought upon her enemies. But the total amount of it—whatever it might be—was not fixed. She was forced to make good different categories of damages. And although the German people had laid down their arms on the clear understanding that only such damage was included as had been done to the civil populations, the cost of pensions and reparation allowance in all allied countries was included in this formula. This not only brought the total damage to a figure greatly surpassing the capacity of Germany for reparation payments, it reduced moreover considerably the percentual share France was to receive. But it did more than that. It convinced the German people that the declarations of the Allies concerning the sanctity of treaties were nothing but sanctimonious piffle which could easily be explained away by clever lawyers' quibbles. The consent of President Wilson, against the well-reasoned arguments of his financial advisers, to the inclusion of war-pensions in the compensation bill, changed the demand for reparation into one of partial indemnity. It knocked, so to speak, the moral bottom out of the whole problem. The rebuilding of the devastated areas in France and Belgium could easily have been conceived by the new Germany as a

sacred moral obligation; the inclusion of pensions was considered a piece of mere financial extortion, brought about by a callous disregard for the solemn obligations on which the armistice was based. In this connection the acknowledgement drawn from Germany, by threats of a further invasion, that she alone was responsible for the war, has always been looked upon as an endeavor to give an artificial moral basis to immoral claims. Instead of convincing the Germans of their supposed iniquities, it has had quite the contrary psychological effect upon them—which might easily have been foreseen.

In days gone by, whenever a big war indemnity had been paid, the receiving country tried to make it worth while for the debtor country to liquidate its debt as quickly as possible. The stupendous effort which France made in 1871 in paying five billion francs to Germany could never have been successful if Germany had not been willing to clear out of France as quickly as possible and to let France alone as soon as she had settled the account. The framers of the Peace of Versailles did not create such a favorable psychological situation. They decreed that the whole of Germany's financial obligation was to be fixed *two years* after the conclusion of peace. And as the different statesmen had told their people that the Germans were to make up all costs, the total sum to be fixed after two years was sure to be unreasonable.

In the meantime Germany was to pay twenty billion gold marks within

two years. This was five times the amount victorious Germany had demanded from France half-a-century earlier. Was Germany, after a four years' war, really five times as wealthy as France had been in 1871? The twenty billions were merely a kind of *hors d'oeuvre* after which the real feast was to begin. An expert body, the Reparation Commission, in which the victorious states were represented, was to fix on May 1, 1921, the total further amount to which Germany was liable. There was a minimum below which Germany's burden was not to fall: her taxation must be as heavy as that of the Allied country most heavily burdened by taxes. There was a maximum: her social and economic system was not to be destroyed by her carrying out her reparation duties. The treaty said nothing about the standards to be used for measuring the incidence of taxation or its influence on Germany's social organization. And it wisely did not do so. For such a standard does not exist, or rather cannot be applied in our present European economic organization, where statistics are rather unreliable. We have no real knowledge of the incomes of all the different countries and in the absence of this knowledge we cannot scientifically compare the relative burden of taxation falling upon their inhabitants. All comparative statistics in that direction are generally guesswork. Until the economics of the world are fairly stabilized, even the most careful statistical investigation will bring little reliable information.

The postponement in fixing the total sum of Germany's liabilities was like putting a premium on financial procrastination. If the twenty billions were found easily and quickly, the conclusion forced on the Reparation Commission must be that Ger-

many was quite capable of bearing additional heavy burdens. If she could put down twenty billions within two years at a time when she was completely exhausted, her capacity for future payments at a time when her economic life was once more normal, should be such as to satisfy the wildest dreams of avarice. When Bismarck took five billions from France he may have been wicked, but he was wise; when the Allied statesmen drew up the financial clauses of the Treaty of Versailles they may have been moral, but they certainly were not wise. They did not offer *ransom* to Germany by the payment of which she would be made safe and free. They framed the political clauses of the treaty, especially the clauses dealing with the occupation of the left bank of the Rhine, not with the view of making Germany pay as quickly as possible, but with the object of maintaining garrisons in Germany.

And they made the payments to be made by Germany as irksome and as ineffectual as possible. Germany was feared as an industrial competitor. She was not allowed to sell goods as freely as possible and hand over the proceeds to the Allies. She was refused the most favored nation treatment, but she was forced to extend it to the Allies. She had to hand over her ships at a time when freights were high; all her assets in enemy countries were confiscated, and the German Government was forced to pay compensation to the owners. She had to give up her best rolling-stock, she had to make huge deliveries of coal at a time when there was a coal famine in Germany and the prices she was credited with were not the world-market prices. In fact, she was made to pay in capital goods and these capital goods were valued far below the price they would have fetched if left

in German hands. The result was, that the total value paid to the Allies did not come to twenty billions, but only to about eight billions, although the loss to Germany far surpassed this sum. And only little of it went to reparations. Most of it was wasted on the armies of occupation.

The Versailles Treaty entitled Germany to make an offer for a lump settlement within four months of the Ratification of Peace. This offer was never made. The German Government, knowing the real state of their resources well enough, could never have made an offer which would have tempted the Allies. They were afraid of making a proposal within the limits of their resources, as the Allies' hopes had been pitched too high. They were willing to develop a scheme at Spa, but this Conference at Spa broke up without a serious discussion of the financial problem. The Spa Conference, abortive as it was in that respect, saved, however, the European situation for some time to come, by providing Germany with considerable credits. These credits enabled Germany to weather the winter 1920-21 by financing imports, and helped her to maintain the course of foreign exchanges at a fairly reasonable level.

II

Immediately after signing the peace, the German exchange, which had of course fluctuated a great deal during the latter days of the war, began to go down rapidly. In January, 1920, the dollar cost about 100 marks (the par being 4.2). The causes of this fall were partly psychological, partly material. The knowledge of the economic conditions of the peace created deep depression in Germany. It seemed impossible that a country, the economic life of which was torn to

pieces by the terms of the treaty, could ever recover when burdened with an uncertain, but huge debt. Germany's balance of commerce had always been adverse; but her balance of payment was favorable owing to her investments abroad and the services of her mercantile marine. Now the greatest part of these investments had been confiscated, the ships were taken away; the demand for imports had risen enormously as the long continuation of the blockade had emptied the country of all stores, whilst the loss of the iron-ore fields and the obligation to deliver increased the proportion of "necessary" imports and decreased the possible exports. The flight from the mark began. Frightened investors exported their capital to invest it in foreign securities, as there were few foreign securities in Germany and as the fear of confiscation hung over them. New heavy taxation was introduced whilst the social order, shaken by revolution, seemed anything but secure. The result was a strong demand for foreign currencies, which could not be stopped by legislation—especially as the occupied districts were practically not under the control of the German authorities. After some time, however, the movement came to a standstill. Foreign speculators, especially in America, took an interest in the mark when it had reached a deep level. Their purchases drove it up and as soon as the fall was arrested "panic buying" ceased and the exchange rose again. When the Spa agreement provided Germany with much needed credits, the exchange was steadied for a long period at about sixty marks the dollar.

During the whole time the German Government had been forced to pay its way by the issue of short termed Treasury Bills. Far-reaching reduction of expenditure was impossible.

As Germany had just failed to go in for Bolshevism it was essential to prevent the spread of unemployment. Moreover, the demands for reparations excluded any retrenchment on a large scale. The revenue from taxation could not be increased quickly; long-term loans could not be placed; the only endeavor in this direction in the autumn of 1919 met with very scant success. Thus the government had to sell Treasury Bills, a large quantity of which was subscribed for by the public. The rest was taken up by the Bank of Germany, which issued notes against them, thus increasing the note circulation considerably. The note circulation, which had risen from 2,303 millions (January, 1914) to 19,444 millions at the close of the war, had reached 35,698 million marks on December 31, 1919 and 68,806 millions on December 31, 1920. Prices rose correspondingly. But it is characteristic that for a long time foreign exchange rose very little, notwithstanding an ever increasing note issue, as the Spa loans and foreigners' investments in Germany temporarily restored the balance of payment.

During this period a series of international conferences (Brussels, Paris, London) vainly tried to bring about an agreement as to the total sum of payments for which Germany was to assume liability. After the London Conference had failed and the Reparation Committee had hurriedly toted up the bill as it was bound to do by the treaty, Germany was presented with an ultimatum demanding from her a payment of a capital sum of 132 billion gold marks. This ultimatum was accepted by Germany under pressure on May 10, 1921, not because she thought it bearable, but because the only way to demonstrate

the impossibility of these demands was to endeavor to comply with them.

III

The 132 billion gold marks (33 billion dollars) represented a capital on which 5 per cent interest and one per cent sinking fund were due. These annual payments would thus have come to 7,920 million gold marks. This annuity could only be paid by the export of German goods. Now German export trade had never been more than 10 billion gold marks; even in the best year the reparation would have taken up 80 per cent of the total exports. As it was, German exports after the war did not rise to more than 4 billions, or to half the amount needed for reparation alone. As imports were about 8 billion gold marks, there was a deficit of the trade balance without taking reparation into account.

The Allies tried to make possible the London agreement by restricting for the time being Germany's annual payments to about 3 billion gold marks. A fixed annuity of 2 billion gold marks was demanded and a variable annuity representing 26 per cent of the value of German exports was supposed to furnish a little more than another billion. At 6 per cent (one per cent sinking fund) these 3 billions represented a capital value of 50 billions. These fifty billions were issued to the Allies as bonds bearing 5 per cent interest and one per cent sinking fund, 12 billions being called Series A, and 38 billions being called Series B; after them came Series C, consisting of 82 billions, payment of interest on which was due only after it had been established that the necessary means were really available. For the time being the annuity consisted of about 3 billion gold marks or 75 per cent of the total value of

German exports. But this was not all. The excess balance due from Germany to the Allies for the settlement of pre-war private debts came to about 480 million gold marks a year. Including some other items the total foreign payments expected from Germany came to nearly 4 billion gold marks a year, or very nearly the total amount of German exports.

The bonds of Series A and B bearing 5 per cent interest, were handed to the Allied Governments, who were supposed to be able to sell them at a good price. These hopes were greatly disappointed, for the general investing public realized that these bonds were not good investments, as the debtor himself had loudly protested his inability to shoulder the burden placed upon him.

The gloomy predictions of Germany were soon borne out. The first billion was paid within the stated period, but with the result that the price of the dollar rose from 69.38 marks in May to 84.31 marks in August.

After some minor fluctuations a catastrophic fall in the mark took place when the League of Nations handed Upper Silesia to the Poles. In November, 1921, the dollar cost 263 marks.

It became evident to the world at large that a country, whose whole balance of payment is unfavorable, cannot pay an indemnity without an utter collapse of the exchange. But this was not acknowledged immediately. It was maintained by the advocates of the London settlement, that the break in the mark exchange was due to the over-issue of bank notes by the German Government. If expenditure were properly reduced and new taxation were levied, no new note issue need take place and no fall in the exchange need follow. These assumptions did not take into account the real facts

of the case. Important economies could not be effectuated, for after the heavy fall of the mark in the summer of 1921 the chief expenditure was no longer optional; it did not depend on the policy of the German Government; it was settled by the London Ultimatum.

The total expenditure of the Reich for German purposes was about 90 billion paper marks according to the estimates for 1922 (February). The total cost for reparations, etc., at the rate of 70 paper marks to one gold mark, (the dollar stood at that time at nearly 300 marks) was well over 250 billions. The bulk of the 90 billions went to pay interest on the debt, pensions, etc., 25 billions consisted in taxes collected by the Central Government for the states; the amount of expenditure on which savings were possible was very inconsiderable. Even if the Reich had had no expenditure of its own, the payment of reparations claimed ever increasing sums when the mark went down. The only efficient economy was a reduction of the reparation payments and that was possible only by means of a moratorium or a loan.

Taxation on the other hand could not be increased automatically whenever a fall of the mark exchange and a corresponding rise of prices increased expenditure. Some revenue no doubt increased automatically with the rise in prices, but many incomes—especially those of the broad middle class—remained stationary, and really diminished, as far as purchasing power was concerned. An interior loan could not be issued, for, with a falling mark exchange, nobody was willing to subscribe to it. The only thing the government could do, was to levy sufficient new taxation to cover the deficit in the regular budget, whenever a fall in the mark had created a new deficit.

The bulk of the reparation payments had to be defrayed by the sale of Treasury Bills, for which the government received bank notes, and by the conversion of these bank notes into foreign currency.

As the demand for marks was always smaller than the demand for gold currency—German exports were four billion marks gold, imports have been valued at six to eight billions, to which three to four billions reparation payments have to be added—the fall in the mark was bound to continue. Even the most drastic taxation could not have stopped it. The balance of payment can of course be influenced by drastic taxation, in so far as taxation reduces consumption, diminishing imports and increasing the available exportable surplus of home-made goods. To achieve this purpose Germany must have raised at least five to six billion gold marks in new taxes—this was about the deficit in the balance of the payments. This equalled about 350 billion paper marks additional taxation and a corresponding reduction in consumption. This was far beyond the tax-bearing capacity of the German people, whose standard of living, especially in the middle classes, was seriously reduced.

It has been agreed that the fall in the mark brought a golden harvest to Germany by giving a lift to export trade. No doubt individuals made an extra profit in paper marks when they sold goods for \$1000 and when, owing to a quick fall of the mark, they netted 300,000 marks when they had expected but 200,000 marks. But the country at large was not a gainer: as the total gold value of imports is about double the amount of exports, the country's balance sheet really became more and more unfavorable. The total bulk of exports did not increase, nor did their value in gold

marks. But speculation became very rife. Whenever the mark went down, the home demand for goods rose rapidly, people encroached upon their capital in order to lay in goods in the fear that prices might go on rising. Traders, speculators and investors competed with each other for the dollar; terrified over an impending future rise of the dollar, their competition drove it up in the present. At the same time, the break in the mark induced owners of marks abroad to cut their losses; new demands for marks did not arise; all forces combined to bring about a panic. On the other hand, whenever there was an upward movement of the mark, the buying of goods stopped at home and abroad, not because Germany cannot compete at a higher level of the mark, but because everybody marked time and awaited a further rise.

Naturally the fall of the mark brought about a flight from the mark, for as the investors realized that an income in mark securities was bound to depreciate, they looked out for gold securities. There are only a few of them dealt with on the German Exchange, and there is always a fear that these few may be sequestered by the German Government acting under orders from the Allied Governments. But there are many pound and dollar notes in Germany; they can be secreted successfully from the tax collector as well as from Allied confiscation. But they do not pay interest, thus depriving Germany of a source of income. Besides this, important balances have been created abroad; they enable the German business world to carry on business abroad at a time when to get credit is difficult and dangerous. But as the income drawn from them rarely enters Germany, it neither improves the balance of payment, nor does it add to the

country's tax revenue. The Allies have often insisted on coercive measures to make the flight from the mark impossible and to force back the capital which has emigrated. There is only one way of bringing about this result: to do away with the necessity of fleeing from the mark by stopping its depreciation.

IV

It was clearly visible in October, 1921, that the London settlement could not be carried out. An agreement had been concluded in Wiesbaden between Germany and France, facilitating the delivery of goods as a means of payment, thus, as it was hoped, diminishing the demand for foreign exchange. This agreement had not borne fruit as it was not ratified for nearly a year. Even if it had been, it could not have prevented a crisis, for at the present time Germany's productive capacity would not have been equal to the strain. The strain had to be lessened.

One way of doing it was by issuing a loan. Germany made frantic efforts to obtain one. In November, 1921, the Bank of England plainly declared that such a loan was impossible as long as Germany's reparation obligations had not been reduced to reasonable proportions. The avenue to a loan being closed, a moratorium was the only alternative left. Such a moratorium would leave France in the cold. She had had scarcely any reparation payments, for the ten billions wrenched from Germany had been frittered away on the up-keep of the Armies of Occupation. She had contracted a reparation debt of about 80 billion paper francs. It would have been easy enough to defray interest and sinking fund on this debt from Germany's payment—two billion gold marks are about five billion paper

francs, but whilst everybody talked reparation, the money which might have been available for these purposes was frittered away.

France realized, however, that the German situation was critical. In Cannes the foundations of a provisional moratorium were laid.

Germany was to pay 720 million gold marks (this is the interest and the sinking fund on the A bonds) and 1,450 million in kind. If the balance due to the Clearing Offices were added, this brought Germany's total obligation to about $2\frac{3}{4}$ billions, a considerable reduction on the London settlement, but, as events were to prove, far beyond Germany's present strength. The Reparation Commission coupled the moratorium with demands for financial and currency reform to be carried out by Germany.

It was hoped that the Genoa Conference would bring a solution of the reparation problem. As France objected to a discussion in Genoa and as most of the time was wasted in arguments with the Russians, no positive results were achieved. Negotiations between the German Government and the Reparation Commission were transferred to Paris, where the German Government engaged themselves to carry out far-reaching financial reforms: to cease the issue of Treasury Bills and of notes if a foreign loan were forthcoming within a reasonable time. Such a loan, the proceeds of which would have gone mostly to France and Belgium, would have diminished Germany's foreign obligation *pro tempore* considerably. It would have greatly reduced her demand for foreign bills and thereby raised immediately the value of the mark; it would at the same time have reduced government expenditure and thus enabled her to balance the budget.

A Committee of Bankers met in Paris. They declared their belief that such a loan could be floated, provided a settlement of Germany's total obligation was arrived at, and provided France desired such a settlement. But as France obstructed the committee, its conclusion was mainly negative.

From that time the present European crisis started. The sands were running out. The mark fell by leaps and bounds. Prices rose rapidly. Scarcity of capital became visible. For as the level of prices and wages was rising at an ever increasing speed the working capital in the hands of industrialists was no longer sufficient.

Credit was not elastic enough. The banks reduced accommodation to pure speculators—with the result that nearly all stock-exchange values crumbled to pieces. Foreign credits were not available on account of the awful risks. Social unrest spread.

The German Government asked for a complete moratorium, including a postponement of clearing office payments. The French Government answered with a series of notes and speeches which created one panic after the other.

It seemed for a moment that the London Conference might bring some relief. But as England refused to cancel France's debt to her, inasmuch as America did not mean to cancel the British debt, no fundamental solution was found.

The Conference centered round the question, whether a further moratorium granted to Germany was to be accompanied by financial control over German forests and German State Mines.

From a constructive point of view this was an entirely futile discussion.

What is needed, and needed quickly, is a complete cessation of all money payments from Germany for the time being, to enable her to restore her currency.

But this cannot be done without creating an atmosphere of confidence. The bickerings which have been going on for the last month have completely shattered all confidence. The present fall of the mark is not due to the economic activities of the business world creating a panic, it is due to a series of panics made by politicians which in their turn are followed by frenzied economic activities of thoroughly frightened people. For the time being the reparation problem has become a purely political problem. Its solution can be approached only after some politicians have learnt their lesson. It may then be too late. But if a solution is still possible it can only be achieved in the following sequence,—1) restoration of confidence, politically,—2) a reasonable moratorium,—3) immediately after the moratorium has been granted negotiations for an interim loan ought to be started, the proceeds of this interim loan to go mainly to France. The restoration of confidence, the moratorium and the interim loan will drive up the level of the mark. It will then be possible to prevent a further fall and to lay the foundation for definite settlement which will give due consideration to the legitimate needs of France, without undermining the foundations of Germany and with it the stability of Europe.

It may, however, be too late. The colossal dilettantism with which the reparation question has been dealt with since the armistice may have made solutions impossible which were clearly within the reach of mankind.